

31st ANNUAL

PAUL J. HARTMAN
STATE AND LOCAL TAX FORUM

Intercompany Transactions on the Hot Seat

October 30, 2024

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Learning Outcomes

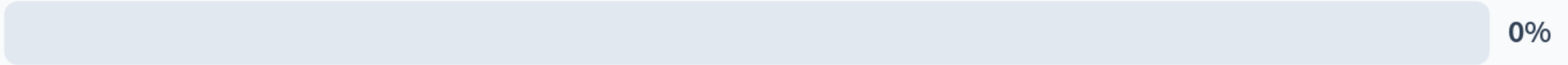
- Understand current state challenges to intercompany transactions
- Identify issues with transfer pricing reports
- Examine current transfer pricing audit issues and how to address them
- Consider ways to properly document and protect transfer pricing methods
- Understand other methods states use to address issues with intercompany transactions

“Nothing exists except atoms and empty space; everything else is opinion” - Democritus

- Anyone may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes. *Helvering v. Gregory*, 69 F.2d 809, 810 (Ct. of App. 2nd Cir. March 19, 1934)
- Further, in the modern world there are many legitimate non-tax reasons to structure a business into multiple entities.

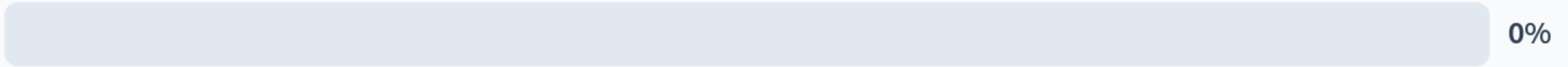
Does your company currently have any domestic intercompany transactions?

Yes



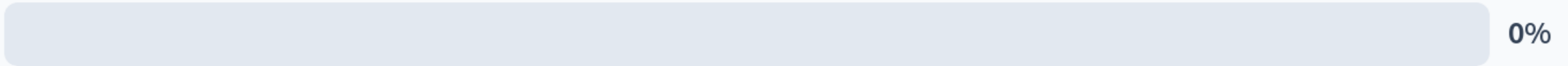
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No



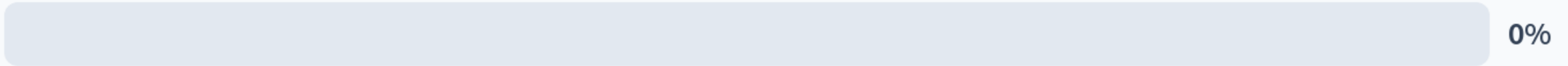
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Background: Transactions Among Affiliated Entities

Sometimes taxpayers, for perfectly legitimate business reasons isolate different business functions into several special purpose entities (separate functions, separate tax reporting entities).

Before Reorganization



After Reorganization



Background: Transactions Among Affiliated Entities

State law measures to address intercompany transactions include:

- Historical measures:
 - Transfer pricing adjustments (state statutes modeled after § 482)
 - Judicial sham transaction doctrine
 - Debt/equity challenges for intercompany interest expenses
- More recent measures:
 - Codification of statutory sham transaction doctrine
 - Adoption of addback regimes
 - Adoption of combined/unitary reporting
- Forced combination or alternative apportionment

Background: Transactions Among Affiliated Entities

States continue to challenge intercompany interest expense

- Intercompany lending and financing structures are common and often essential to operations. They may involve
 - cash management systems (sweep accounts)
 - acquisition debt, with affiliate acting as central finance company
- States may deny intercompany interest expense deductions under federal debt/equity analysis and/or statutory addback rules.
- In unitary/combined reporting states, lending from foreign affiliates may still give rise to intercompany interest challenges.

Transfer Pricing: The Basics

- Transfer pricing is the pricing of transactions between related entities for goods, intangible assets, services and loans.
- It is designed to prevent tax avoidance among related entities by requiring pricing that places controlled transactions on par with transactions between unrelated parties.
 - However, a tax evasion or avoidance motive is generally not a prerequisite for application of a transfer pricing adjustment.
- Transactions generally must be at arm's length.
 - Use “comparables” for arm's length standard because identical transactions are usually not available.

Transfer Pricing: The Basics

- Transfer pricing adjustments are used primarily in separate reporting states
- Most states either adopt § 482 or have similar arm's length rules.
 - The tax collector reviews transactions between related parties (having common ownership) and seeks to determine whether the transactions are priced as they would be if the parties were unrelated
 - – i.e., whether the related-party transactions were made based on arm's length standards
- Must states with transfer pricing statutes similar to § 482 follow federal regulations and guidelines?

Transfer Pricing: The Basics

- Nearly every state adopts some statutory regime to adjust prices of intercompany transactions based on:
 - Express adoption of IRC § 482 or provisions substantially similar to IRC § 482.
 - Statutory language broader than IRC § 482 authority.
 - General federal conformity or general discretionary authority.
 - Notable states that do not: Delaware, New Mexico, and Pennsylvania.

Transfer Pricing: The Basics (Federal Law & Principles)

- Transfer pricing is generally governed by IRC § 482, (extensive) accompanying regulations, judicial decisions, disciplined procedures.
- Key components of the IRC § 482 regulations:
 - *Arm's Length Principle*
 - Results of the transaction are consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances.
 - *Best Method Rule*
 - A method that provides the most reliable measure of an arm's length result under the facts and circumstances of the particular transaction.
 - *Comparability*
 - Specific factors should be considered when determining comparability.
- IRC § 482 is not self-executing. It provides the IRS discretion to make adjustments.

Transfer Pricing: The Basics (Federal Law & Principles)

“Does *Chevron’s* Demise Matter in Transfer Pricing?” (Ryan Finley, Tax Notes State, July 15, 2024)

- “*Loper Bright* will surely prompt a flood of new substantive validity challenges and, as the majority either intended or didn’t care to prevent, jam a huge wrench in the gears of governance. . . . But not all regulations are equally at risk, and there’s good reason to believe the [section 482](#) regulations are better insulated than many others.”
- “The authority to reallocate income and deductions under [section 482](#) arises ‘if [the Secretary] determines’ (emphasis added) that the reallocation ‘is necessary in order to prevent evasion of taxes or clearly to reflect . . . income.’”
- “In other words, the first sentence of [section 482](#) falls squarely within the discretion-delegating category acknowledged in *Loper Bright*.”

Transfer Pricing: The Basics (Federal Law & Principles)

“Does *Chevron*’s Demise Matter in Transfer Pricing?” (Ryan Finley, Tax Notes State, July 15, 2024)

- “The [section 482](#) regulations, which specify how the secretary’s discretionary determinations will be made in particular cases, commit Treasury and the IRS to exercise their discretion in a specific way. When assessing the substantive validity of the [section 482](#) regulations in accordance with Loper Bright, courts must recognize this delegation and fix its boundaries.”
- “Recognizing that Congress delegated to the Treasury secretary discretion to specify transfer pricing methods, impose reliability criteria, and set comparability standards doesn’t definitively establish the validity of every word in the [section 482](#) regulations. . . . *But the foundational provisions that govern the selection and application of transfer pricing methods are entitled to judicial deference now just as they were under Chevron.*” (Emphasis added).

Transfer Pricing: The Basics (Federal Law & Principles)

“Does *Chevron’s* Demise Matter in Transfer Pricing?” (Ryan Finley, Tax Notes State, July 15, 2024)

- “Under *Loper Bright*, failing to [set out the statutory basis for their regulations when they are promulgated] already entails an implied penalty. According to the majority opinion, a contemporaneous agency interpretation that remains consistent over time ‘may be especially useful in determining the statute’s meaning.’”

Transfer Pricing: Typical Intercompany Transactions Appropriate for Support via Transfer Pricing

- Transfer and licensing of intangible assets
- Providing and charging for routine administrative services
- Providing and charging for valuable strategic services
- Financing
- Factoring accounts receivables
- Sale of tangible goods that may contain intangible component
- Purchase and resale of tangible goods

Overview: State Initiatives To Resolve Intercompany Transaction Issues

Indiana

Formed a transfer pricing group within its Audit Division in 2018 and implemented an APA program in 2020.

North Carolina

Offered a program that allowed taxpayers to approach and settle on agreed pricing. The program ran from August to December 2020.

Louisiana

Held voluntary program that allowed taxpayers to conduct managed audits to resolve intercompany transfer pricing issues, including prospective application.

South Carolina

Litigating cases involving Department of Revenue policy to force unitary combination as resolution to transfer pricing disputes (see S.C. Rev. Rul. 15-5 (6/12/2015)).

Overview: State Trends in Transfer Pricing Audits

- Increasing scrutiny on transfer pricing studies and application of the arm's-length standard.
- Increased focus on developing technical knowledge under 482.
- Increasing reliance on contingency fee auditors.
- States have begun producing in-depth audit reports with respect to intercompany transactions and 482 analysis

Overview: State Trends in Transfer Pricing Audits

- **Wider scope of intercompany transactions** - not just interest/royalties anymore:
 - *CarMax Auto Superstores Inc. v. Department of Revenue*, No. 21-ALJ-17-0182-CC (S.C. Admin. Law Ct. July 12, 2024)
 - *See's Candies Inc. v. Auditing Division of the Utah State Tax Commission*, No. 140401556 (Utah 4th Judicial Dist. Ct. 2016)
 - *Columbia Sportswear USA Corp. v. Indiana Department of Revenue*, No. 49T10-1104-TA-00032 (Ind. Tax Ct. 2015)
 - *Microsoft Corporation v. Office of Tax and Revenue, District of Columbia Office of Administrative Hearings*, No. 2010-OTR-00012, May 1, 2012.

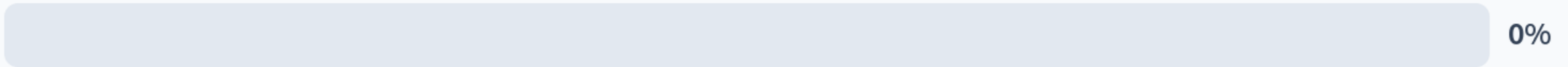
Transfer Pricing: the Comparable Profits Method

Methodology –

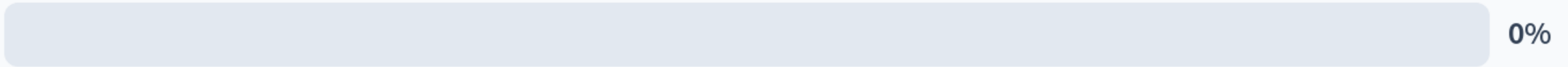
- Comparable Profits Method is the most frequently utilized method in APAs at the IRS level
- State tax agencies utilize third party consultants or databases in an effort to identify comparable companies that engage in activities similar to the taxpayer which results in common issues such as:
 - Failure to use or consider any method other than the CPM
 - Comparables based on auditor's understanding of the taxpayer's activities without consideration of specific functions relevant to the intercompany transactions at issue
 - Issues with third party databases - Auditor attempts to locate perceived comparables in a proprietary third-party database that purports to compile royalty rates extracted from unredacted license agreements filed with the SEC
 - Reliance on largely undisclosed subjective and objective criteria to narrow the list of comparable entities, such as excluding any comparable entity with losses

How often should a business prepare and review its state transfer pricing study and support documentation?

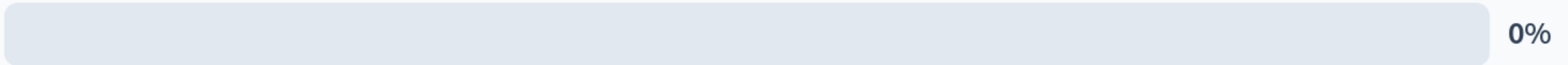
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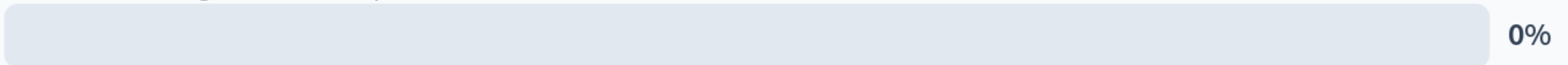
Every 2-3 years



Every presidential election cycle



Wait, those things need to be updated?



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Best Practices in Documentation



Best Practices

- Businesses often have international transfer pricing information prepared by third parties for federal tax purposes but have not tracked that information on an interstate basis.
- A DOR may not accept a taxpayer's third-party transfer pricing study, even if IRS has accepted the study and agreed that federal taxable income was correctly reported.
- Properly documenting intercompany transactions is key to achieving correct results in a transfer pricing audit.
- Related taxpayers that engage in multi-state or international intercompany transactions should review their intercompany agreements and carefully document any intercompany transactions.
 - Documentation should include a determination of the functions performed and assets employed by each party to the transaction as well as any risks assumed related to the transaction.
 - Taxpayers should also regularly review and update their transfer pricing studies and internal transfer pricing methodology.

Best practices

- Items that should likely be included in transfer pricing documentation reports to support price paid for intercompany transactions
 - overview of the business (including economic and legal factors that affect pricing)
 - description of taxpayer's organization structure (all related parties engaged directly or indirectly in intercompany transactions or affecting the pricing in such transactions)
 - documentation explicitly required under Sec. 482
 - description of the method selected and an explanation of why that method was selected
 - description of the alternative methods that were considered and an explanation of why they were not selected
 - description of the controlled transactions
 - description of comparable analysis, including adjustments
 - explanation of the economic analysis and projections relied upon in developing the method
 - general index of the principal and background documents and a description of the recordkeeping system used for cataloging and accessing those documents
 - Copies relevant to the decisions to include/exclude comparables; copies of relevant agreements used in the transfer pricing analysis

Best practices

Regularly update transfer pricing study

- Review updates to laws in key states
- Discuss and update facts and make sure that factual explanation in study is consistent with facts on the ground
- Track documents provided to study firm for use in analysis

Recent Cases: Louisiana

- ***Kevin Richard v. ConocoPhillips Co.***, Dkt. No. C-740344 (La. 19th J.D.C. Nov. 27, 2023)
 - Louisiana filed suit for \$390 million in taxes allegedly owed by ConocoPhillips from 2008-2011.
 - Louisiana's claim was based on using the CPM to analyze the taxpayer's operating margins as a whole.
 - ConocoPhillips, citing Section 482 regulations, argued that the best method is comparable uncontrolled price because it purchases oil from third-parties at arm's length.
 - Case settled earlier this year

Recent Cases: South Carolina (Forced Combination)

- ***Tractor Supply Co. v. South Carolina Department of Revenue***, No. 19-ALJ-17-0416-CC (S.C. Admin. Law Ct. Dec. 4, 2023)
 - The ALJ concluded that the intercompany transactions were not at arm's length and held that the DOR had the authority to require combined unitary reporting as an alternative apportionment method.
- ***CarMax Auto Superstores Inc. v. Department of Revenue***, No. 21-ALJ-17-0182-CC (S.C. Admin. Law Ct. July 12, 2024)
 - Upheld combined unitary reporting as alternative apportionment method.

Legislative Updates: South Carolina

- ***South Carolina Senate Bill 298***
 - Effective March 11, 2024
 - Limits DOR authority to adjust intercompany transactions under S.C. Code Section 12-6-2320 to require a finding that the transactions lack economic substance or are not at fair market value.
 - To determine FMV, the DOR must apply federal transfer pricing standards from Section 482 regulations.
 - Allowed adjustments to taxpayer's income:
 - Adding back, eliminating, or otherwise adjusting intercompany transactions
 - Mandatory combined reporting for unitary group

Legislative Update: South Carolina (cont'd)

The legislation defines “affiliated group” and lists entities that must not be included in a combined return.

- A taxpayer not required to file a federal income tax return;
- Certain qualifying insurance companies, other than a captive;
- A taxpayer exempt under Section 501;
- A foreign taxpayer as defined in Section 7701, other than a domestic branch thereof;
- An 80/20 company; and
- Any other entity not subject to South Carolina corporate income tax.

Legislative Update: South Carolina (cont'd)

- A transaction has economic substance if the transaction, or the series of transactions of which the transaction is a part:
 - Has one or more reasonable business purposes other than the creation of a state income tax benefit, and;
 - Has economic effects beyond the creation of state income tax benefits, which may be satisfied by demonstrating material business activity of the entities involved in the transaction.
- Centralized cash management of an affiliated group does not constitute evidence of an absence of economic substance.
- However, achieving a financial accounting benefit will not be viewed as a reasonable business purpose if the origin of such financial accounting benefit is a reduction in state income tax.

Legislative Update: South Carolina (cont'd)

- A taxpayer may request advice from the Department regarding whether a redetermination of the taxpayer's state net income or a combined return would be required under certain facts and circumstances.
- The Department must provide its advice within 120 days of the receipt of any requested information from the taxpayer.
- However, the Department's advice does not constitute a Department redetermination under the Revenue Procedures Act.

Legislative Update: South Carolina (cont'd)

- If the taxpayer appeals a final determination by the Department under these provisions to the Administrative Law Court, the administrative law judge must review **de novo**:
 - Whether the separate income tax returns submitted by the taxpayer fail to fairly represent the extent of the taxpayer's business activity in the state through the use of intercompany transactions that lack economic substance or are not at fair market value;
 - Whether the Department's means of determining the taxpayer's state net income is appropriate; and
 - If a combined return is required by the Department, whether adjustments other than requiring the taxpayer to file a return on a combined basis are adequate to redetermine state net income.

Information Sharing and Confidentiality

- **Confidentiality**
 - Tax departments may share information with other states
 - Confidentiality agreements may be available
 - Protecting information in litigation



Questions?

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